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Behavioral corporate governance

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1. Introduction

In 1602, the frontrunner of the modern enterprise was established with the incorporation of the Dutch East India Company, VOC (example taken from Frentrop, 2002: 55-111). Earlier, the journeys of Dutch vessels exploring trade opportunities had been financed through debt-like arrangements where investors recollected their contribution plus an interest payment. The VOC, however, was financed through contributions that would be reinvested rather than being returned to the investors when the ships reached their home base. Instead, a dividend was paid when VOC profits were substantial enough. The securities through which the East India Company was financed can, therefore, be considered the first equity stakes in a public company. Although managers of the VOC were required to hold some shares, most were held by outside investors. Berle and Means (1932) would, some 330 years later, characterize this situation as a modern corporation with a separation of ownership and control. Another forty years thereafter, the problems associated with such a separation would be formalized by Jensen and Meckling (1976), since then known as the principal-agent problem.

The shareholders of the East India Company were not in need of the elegant math with which Jensen and Meckling (1976) derived the potentially detrimental effects of the separation of investors from managers on their return. They would themselves experience these problems. The managers of the VOC, each of whom ran a trading company of his own, realized that their private benefits were greatly enhanced when the spices, imported from what now is the Republic of Indonesia, were sold to their own trading company below the market price, instead of being offered on the market by the VOC. Obviously, the effects of this transfer pricing policy on VOC profits were noticeable, and dividends could soon not be distributed anymore. Some shareholders did revolt against this practice, but their efforts were without effect as the managers of the VOC also had important positions in local government offices. Effectively, state intervention was thus minimal as the governors preferred to remain on good terms with VOC management rather than with the revolting shareholders. Finally, when there was insufficient capital to finance another trading company, the West India Company, the national government intervened in VOC governance. Some years later, a steady flow of dividends appeased shareholders (Frentrop, 2002).

The VOC case excellently shows that corporate governance problems are not restricted to recent headline-hitting scandals, such as those surrounding Enron, Tyco, or the Dutch food retailer Ahold. Corporate governance refers to “the system by which companies are controlled and directed” (Charkham, 1994: 1). It is straightforward to phrase the East India Company problems in terms of modern-day corporate governance vocabulary. On the

one hand, managerial *agents* did not have the appropriate *incentives* to maximize *total shareholder return* as they held only a fraction of company stock. On the other hand, they did perceive the full benefits of their *consumption of perquisites*, and were thus tempted to sell company products to their own trading companies below the market price. *Minority shareholders* did not have the *voting power* to affect company practice. Moreover, as the agents held *interlocking directorates* with governmental bodies, these were potentially co-opted and courts would not rule in the benefit of the shareholders. Finally, however, *shareholder activism* did result in a continuous stream of dividends, appeasing investors' demands, as other firms sought funding in the capital market as well.

While the governance problems associated with large corporations may not have changed fundamentally in the past centuries, the academic debate has experienced a significant development over the past few decades. In the next section, I discuss an economic perspective on corporate governance. Subsequently, I discuss a behavioral perspective, which is central to the chapters developed in this book. Finally, I outline the organization of the book, and locate the chapters in the behavioral perspective.

1.1 An economic perspective on corporate governance

With technology improvements and mass production, the minimum efficient scale of operations increased during the 19th and 20th centuries. Consequently, entrepreneurs were increasingly unable to finance the assets out of their own pockets, and ownership of corporations became separated from control over the assets. Corporations are managed by individuals who have superior knowledge to efficiently succeed in the marketplace, yet these managers lack the resources to finance the operations. Investors have sufficient resources yet they lack the skills or motives to do business. With the transfer of resources from investors to managers also comes the problem of how to safeguard the interests of the investor. What guarantees that the manager (agent) would use the investors' (principal) resources to the purpose that has been stipulated in the articles of incorporation? This problem is known in economics as the principal-agent problem. Agency theory was developed mainly in the 1970s and 1980s (Eisenhardt, 1989; Fama and Jensen, 1983; Jensen and Meckling, 1976). Corporate governance, in this tradition, is defined as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997: 737).

The core concern in the economic perspective on corporate governance is to find feasible solutions for the agency problem. As firms are conceived of as a nexus of contracts, these solutions are sought after in the manager's employment contract. In an ideal world, with

perfect knowledge and costless enforcement of contracts, the contract would stipulate exactly how the manager would act in each contingency. There are several problems associated with this ideal world. First, if investors would know (beforehand) how to act in each contingency, there would be no need for an agent to manage the corporation. In practice, however, asymmetric information affects both the extent to which contracts can be prescriptive as to the agent's behavior and the extent to which the investor is able to control whether the articles of the contract have been lived after. Second, enforcement is costly, and agents would thus have some leeway in implementing the agreement after it has been signed, a phenomenon known as moral hazard (Milgrom and Roberts, 1992). If moral hazard is substantial, investors may factor in the expected disobedience and decide not to hire an agent in the first place, implying that economic rents would not be realized. In a second-best world, investors provide the agent with incentives to act in line with the shareholder's demands. These incentives are, for example, contained in a compensation contract, which stipulates that the highest pay level is associated with high firm performance. Also, boards of directors monitor managerial behavior, and outside markets, such as the market for corporate control, may restrict the extent to which managers engage in opportunistic activities. Board monitoring in this perspective thus solves for the collective action problem that minority investors in widely held firms face.

The economic approach to corporate governance lends itself well to the analysis of contract designs and bargaining games. The literature has resulted in several strong policy prescriptions that have increasingly been implemented in hard and soft laws. Economists suggest that boards of directors be installed which monitor management on the shareholders' behalf (Fama and Jensen, 1983). Moreover, such directors should be independent from the management of the company for them not to perceive a disutility of making tough decisions (Dalton, Hitt, Certo and Dalton, 2008). Furthermore, executive compensation would better be tied to company performance through long-term incentive plans (Hall and Liebman, 1998; Jensen and Murphy, 1990). Unfortunately, decades of empirical studies do not corroborate these findings as meta-analyses of board composition, independence, size, leaderships structure, and equity compensation, on the one hand, and firm performance, on the other hand, do not demonstrate robust causal relationships (e.g., Dalton, Daily, Ellstrand and Johnson, 1998; Dalton, Daily, Johnson and Ellstrand, 1999; Dalton et al., 2008; Hermalin and Weisbach, 2003; Tosi, Werner, Katz and Gomez-Mejia, 2000).

As a consequence, some scholars have called for approaches to corporate governance that relax some of the assumptions common to the economic perspective. Table 1.1 presents a classification of perspectives on corporate governance, which is taken from Hambrick, Von Werder and Zajac (2008). The table combines two dimensions in a 2x3 matrix. The first dimension entails whether the perspective takes relationships inside the corporation

(organization inward) as its key focus, or whether these relationships are with outside constituents (organization outward). The second dimension deals with the topic under study: formal structure, behavioral (informal) structure, or behavioral processes. Cross-tabulating these dimensions yields a classification which is instructive, yet does not suggest that, for example, legal scholars exclusively look at external corporate governance structures

TABLE 1.1
Classification of Perspectives on Corporate Governance

| | Formal structure | Behavioral structure | Behavioral processes |
|----------------------|------------------|----------------------|----------------------|
| Organization inward | Economics | Power | Social psychology |
| Organization outward | Legal/Economics | Social Networks | Symbolic Management |

Loosely based on Hambrick et al. (2008).

According to Table 1.1, the economic perspective is well-suited for the focus on structural aspects of internal corporate governance relations. Economic modeling is able to derive empirical predictions regarding the optimal design of the contract between the manager and the investor. Economists have also studied legislation and codes, for example in the area of corporation law or stock exchange listing requirements. It is argued, however, that for the study of informal structures and behavioral processes inside and outside the boardroom, other approaches are better equipped (Van Ees, Gabrielsson and Huse, 2005; Zajac and Westphal, 1998). In the next section, I sketch some key concepts in a behavioral perspective on corporate governance. It is postulated that this perspective may add to our understanding of governance problems and their solution.

1.2 A behavioral perspective on corporate governance

A large literature developed in the 1990s enriching each of the cells in Table 1.1 with insights from behavioral theories. These theories have their roots in psychology, and sociology, and are brought to the corporate governance field through the behavioral theory of the firm (Cyert and March, 1963), resource dependence theory (Pfeffer and Salancik, 1978), the resource-based view (Barney, 1991) and others. It is beyond the scope of this introduction

to review this literature.¹ Several differences with the economic perspective are noteworthy, though.

Firstly, and foremost, behavioral studies do not focus as much on contracts. Instead, an input-throughput-output model is implicit in most studies. These studies target informal structures and behavioral processes (Table 1.1). The focus lies on antecedents and consequences of decisions made by chief executive officers (CEOs), non-executive directors, and other key constituents of the firm (Huse, 2007). The problems under study depend on the actors who are deemed salient, and the behavioral approach thus fits a stakeholder model (Freeman, 1984) better than a shareholder supremacy model. Actors' personalities, knowledge, positions and the like impact on their decisions (Forbes and Milliken, 1999). As decisions at the top of firms tend to be taken by teams, interactions inside these teams are relevant. Finally, decisions have effects on corporate outcomes, and are interpreted by individuals (Huse, 2007). In the economic perspective, the rationality assumption implies that when the formal structures are adequate, outcomes will follow automatically, and thus there is no need for studying informal structures and behavioral processes when trying to gain insight in board effectiveness.

Secondly, due to the multitude of mediating and moderating effects, and the endogenous nature of the relationships under study, there tends to be less of an emphasis on mathematical modeling than is the case under the economic perspective. Instead, theoretical models are developed, where the key skill of the researcher is to formulate a model which includes all relevant concepts, while keeping a keen eye on the complexity of the framework. Finally, the purpose of the corporate governance system is not necessarily to safeguard the interests of the shareholders alone. Rather, the support of other internal and external contingencies is considered vital for the prosperity of the firm.

A behavioral perspective on corporate governance acknowledges that micro-social forces, derived from social psychology, and macro-social forces, derived from sociology, affect board outcomes (Zajac and Westpahl, 1998; see also Daily, Dalton and Cannella, 2003). Micro-social forces refer to interpersonal influencing tactics, which are not present in economic modelling as rational self-serving behavior implies the absence of relationships. If a relationship between the CEO and the board would exist, concerns over the preservation of this relationship would cause deviations from rationally derived solutions. For example, whereas economic principles prescribe that the best candidate is selected to fill a board position, it has been shown that individuals prefer to nominate demographically similar

¹ As there are 6,700 academic papers on corporate governance included in the EBSCO database (as of June 2008), it is virtually impossible to give a review of the literature pertaining to even one cell of Figure 1.1.

candidates (Westphal and Zajac, 1996), and that flattery and ingratiation among directors affect the probability that future positions will be secured (Westphal and Stern, 2007). These forces may cause deviations from contracting solutions, but these are not necessarily inefficient. After all, the partial contracting solution is (also) costly, and it may be that keeping individuals in line through social tactics is superior in terms of a cost-benefit trade-off as to solving the principal-agent problem than a contracting solution (Zajac and Westphal, 1998). A behavioral perspective on corporate governance from the micro-social point of view thus calls for the inclusion of social psychological insights and power relations (see Table 1.1). Next to formal structures, board performance is affected by informal structures (power relations) and behavioral processes.

Macro-social forces may also influence board performance. A behavioral perspective acknowledges that not only is the firm embedded in and interdependent with other organizations (Pfeffer and Salancik), but also that directors, CEOs and other top individuals are part of a social elite. When the assumption of self-interest maximization is dropped, and replaced with, for example, satisficing behavior, the optimal outcome is no longer defined. Outcomes are the result of a bargaining process among interested parties, and change only occurs when problems are deemed salient (Cyert and March, 1963; Van Ees et al., 2005). Consequently, norms as to what outcomes are desirable are no longer objectively derived, and members of the corporate elite may compare their own outcomes to those of other members they deem socially comparable to themselves. It has indeed been shown that such social comparison takes place in the area of director compensation (O'Reilly, Main and Crystal, 1988). Thus, norms that operate within the context of social elites may function as devices of normative pressure on decision-makers (DiMaggio and Powell, 1983). The study of the managerial elites has frequently taken place through interlock research, where individuals who hold multiple positions within an elitist community (for example, CEO of one company and outside director of another) spread practices throughout the network (e.g., Pennings, 1980).

Applying this behavioral perspective to corporate governance has important implications, of which a few are mentioned here. First, as organizational change is only expected in cases of obvious problems, it is expected that no benefits are derived from costly investments in strategies that will raise outcomes even further above the aspiration level. This relates to perceptual framing, a notion that has been implemented in prospect decision theory (Kahneman and Tversky, 1979). According to this theory, which will be used in one of the thesis' chapters, the status quo affects firm strategic decisions. Thus, although a corporate governance practice may be considered best by some stakeholders, its implementation does not necessarily have a positive affect on firm outcomes, if the status quo is not considered problematic by other stakeholders.

Second, as bargaining takes place among relevant actors, the decision of which stakeholder will be included in a research endeavor becomes salient. In this thesis, the core focus is on relationships among managers, shareholders, and outside directors. For the purpose of one of the chapters, other stakeholders are also – and jointly – considered. I do not, however, focus on suppliers of intermediate products, and creditors to the firm. Depending on the selection of stakeholders, topics may be considered problematic or not. The main message of a behavioral perspective on corporate governance is, however, that next to formal decision making structures, informal structures and behavioral processes are to be considered in order to gain insights into what boards actually do.

1.3 Organization of the book

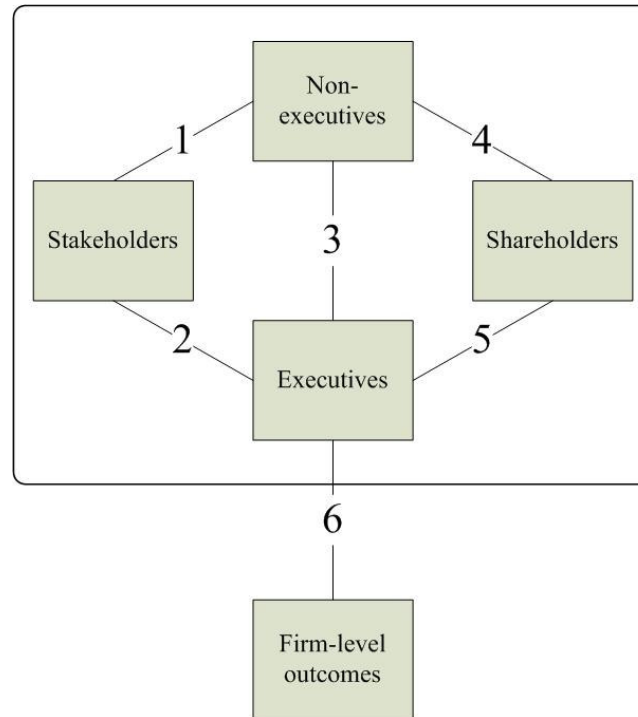
The four subsequent chapters are academic papers in the tradition of the behavioral perspective on corporate governance. The chapters all focus on different research problems, and concern relationships between different stakeholders in the organization. Common to the chapters is that they all are empirical in nature, and that they focus on relationships at the top of corporations. Figure 1.1 presents an overview of the relevant actors included in the chapters, and their possible interrelations. The figure holds that the interactions among executives – including the CEO –, non-executive directors, shareholders and other stakeholders jointly determine firm-level outcomes.

Chapter 2 analyzes the relationship between the CEO and the board chairperson (line 3 in Figure 1.1). According to Zahra and Pearce (1989), this relationship serves two purposes. First, directors owe it to the shareholders to monitor managers' behavior, and to check whether this is in line with the investors' expectations. Second, directors are expected to provide expert advice on strategic matters to the executives. The main argument in this chapter relates to the assumption in (economic) agency theory that independence is the key to board monitoring. Our² argument criticizes the fundamental assumption of the arms-length bargain as the most appropriate description of the interaction between the board and the management. Here, every single board decision is conceptualized as a discrete event, and therefore dependence will not occur. We argue, on the contrary, that this description is not accurate as a conceptualization of interactions inside the boardroom. Rather, it is suggested that boards engage in a social contract (Huse, 1993; MacNeil, 1980), in which norms relating to the preservation of the relationship are present. These norms facilitate the development of trust, and this is, among other effects, good for information exchange. Thus, we argue that

² As the underlying papers are joint work, with the exception of Chapter 5, I use the 'we' form throughout the chapters to acknowledge the contribution of the co-authors.

there may actually be a positive relationship between proximity and board monitoring performance. While proximate boards are suggested to be less independent from management than distant boards, they have superior access to information which can subsequently be applied to the job. These arguments are tested, using Huse's 2003 survey data for Norwegian boards in both stock-listed and private firms.

FIGURE 1.1
Relevant actors



Chapter 3 concerns perceptual framing and stakeholder exchanges with the corporation, and is particularly focused on line 2 in Figure 1.1. The argument combines prospect decision theory (Kahneman and Tversky, 1979) and the corporate social performance-financial performance literature (Margolis and Walsh, 2003). The argument, in line with a behavioral perspective on the governance of these relationships, is that managers are more likely to respond to negative reputations for their involvement in social relations than to positive reputations. When the aspiration level has been reached, corporate social performance (CSP) is simply not seen as a problem anymore, and managers will not search for additional improvements. The second line of argumentation builds directly on stakeholder theory's distinction between primary and secondary stakeholders (Clarkson, 1995). Secondary stakeholders are those who are affected by the firm, whereas primary stakeholders also have an effect on the firm. It has commonly been argued that primary stakeholders are more important to the firm, and therefore that the firm would be more responsive to their needs

(Hillman and Keim, 2001). Notwithstanding this argument, we suggest that a reputation for social performance is more relevant for secondary stakeholders. Primary stakeholders, after all, have frequent exchanges with the company, by definition. From these exchanges, information is obtained, and thus a reputation for CSP provides little additional information as to how the company deals with them. For example, employees experience safety in the workplace themselves, and are not in need of an externally constructed reputation for employee relations in order to evaluate the company's involvement in their concerns. We test these arguments with Kinder, Lydenberg and Domini (KLD) social performance ratings for 1997-2002, including all Standard & Poors 500 firms.

Chapter 4 takes the decision whether or not to comply with soft law as its topic. The relationships under study are those between managers, on the one hand, and shareholders and non-executives, on the other hand (lines 3 and 5 in Figure 1.1). Corporate governance codes are a type of soft laws introduced by, usually, stock exchanges, governments or employer's associations. These codes contain many provisions as to how the rights and duties of executives and non-executives vis-à-vis each other and the investors are specified. Whether or not firms comply with these so-called best practice provisions, is conceived of, in this chapter, as a bargaining game. We introduce a classification of provisions, based on the extent to which managers will feel restricted in their discretion by implementing the provision. Subsequently, we argue that in the bargain over the implementation of these provisions, managers will contest the usefulness of doing so. Whether or not implementation is observed is then argued to depend on the extent to which other parties have power over the CEO. Specifically, we argue that powerful and independent boards of directors will be able to force CEOs to implement these practices. Also, when a firm takes a central position in a network of firms, we contend that peer pressure will also be a source of compliance. The argument is tested using a database with compliance information for the Dutch corporate governance code in 2004 (Akkermans et al., 2005).

Chapter 5 studies executive compensation, which has been a hotly debated issue in the corporate governance discussion for ages.³ The chapter, in a way, is an extension of Chapter 2 and focuses on the relations among non-executives, shareholders, and the CEO (thus the lines 3 and 5 in Figure 1.1). The economic model of executive compensation contends that bargaining over the CEO compensation contract takes place at arms' length. Directors propose a contract to the CEO(-candidate), which is attractive enough for the CEO

³ Literally so, since the revolting VOC shareholders mentioned earlier in this introduction were upset over information disclosure, their inability to fire managers, and the remuneration of these managers (Frentrop, 2002). Thus, the topics that agitate shareholders these days, also agitated their ancestors four centuries ago.

just not to refuse it. An alternative hypothesis is based on the managerial power theory (Bebchuk and Fried, 2004), in which it is argued that CEOs have substantial power over their boards. Thus, bargaining over the compensation contract does not take place at arms' length. Consequently, the CEO is able to affect the design, level, and performance sensitivity of the compensation. We test the hypothesis that power is related to compensation with an extensive dataset for The Netherlands for 2002-2006 (Van Ees, Van der Laan, Engesaeth and Selker, 2007).

TABLE 1.2
Thesis Chapters and the Classification in Table 1.1

| | Formal structure | Behavioral structure | Behavioral processes |
|----------------------|------------------|----------------------|----------------------|
| Organization inward | – | Chapter 5 | Chapter 2 |
| Organization outward | Chapter 4 | Chapter 4 | Chapter 3 |

Referring back to the classification presented in Table 1.1, it is clear that the various chapters cover many cells in this table, as is apparent from Table 1.2. The study contains no real assessment of internal formal governance structures, although one may conceive of Chapter 5 (about incentive contracts) as one. It is not placed in this cell, however, as the focus is on power struggles between the directors and the CEO, and is thus better seen through the lens of informal structures inside the corporation. Chapter 2 also involves an inward perspective on the company, since it deals with norms and trust inside the boardroom. Chapter 4 is placed in two cells. Mainly, it concerns the informal structures that regulate the adoption of provisions contained in corporate governance codes. As these micro-level decisions also have bearing on the macro-level compliance figures with national corporate governance codes, contained in soft law, the chapter is also mentioned in the formal structure column. Finally, Chapter 3 focuses on the interactions among the firm's managers and the outside stakeholders, and therefore falls in the category of behavioral processes targeted at external relations. Obviously, this classification is not as distinctive as it may seem, since Chapter 3 also includes internal stakeholders (notably, the employees), and since depending on whether one reckons shareholders and directors as internal or external actors, the chapters in the behavioral structure column may switch places.

It is, finally, worth mentioning that two relationships have not been dealt with in this PhD thesis, namely relations 1 (stakeholders and non-executive directors) and 4 (shareholders and non-executive directors) in Figure 1.1. It is striking that in spite of the large literature discussing the principal-agent problem, there is hardly any discussion of the motives of outside directors to satisfy the shareholders' mandate to control managers. There is a large literature on how formal structures affect firm performance, focusing on the number of non-

executive directors, for example, but this literature is largely inconclusive (Hermalin and Weisbach, 2003). Also, and particularly since there are some indications that outside directors are more tuned into social responsibility issues than managers (Ibrahim, Howard and Angelidis, 2003), there is a lack of understanding as to what role outside directors may play in the corporate social responsibility strategy of a firm.

